

Spring 2006

Counseling Organizational Clients "Within the Bounds of the Law"

Roger C. Cramton

Cornell Law School, rcc10@cornell.edu

Follow this and additional works at: <http://scholarship.law.cornell.edu/facpub>



Part of the [Corporation and Enterprise Law Commons](#), [Ethics and Professional Responsibility Commons](#), and the [Legal Profession Commons](#)

Recommended Citation

Cramton, Roger C., "Counseling Organizational Clients "Within the Bounds of the Law"" (2006). *Cornell Law Faculty Publications*. Paper 1215.

<http://scholarship.law.cornell.edu/facpub/1215>

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

COUNSELING ORGANIZATIONAL CLIENTS “WITHIN THE BOUNDS OF THE LAW”

*Roger C. Cramton**

I. THE COUNSELING FUNCTION

The principal function of lawyers is to communicate the lawyer's knowledge of law to the client and apply it to the client's situation. Thus, every lawyer who has clients, whatever else they do, is a counselor. Two professional rules deal directly with counseling: Model Rule 1.2 deals with scope of representation, allocation of authority between lawyer and client, and prohibits a lawyer from counseling a client “to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent”¹ Model Rule 2.1 requires a lawyer to “render candid advice” in the exercise of the lawyer's “independent professional judgment.”² That means, I believe, that the lawyer should level with the client by communicating the law in all its sometimes certainty and often ambiguity to the client, thus helping the client to act in a way that is most likely to achieve the client's objectives; in short, to help the client understand the law as it is and how it provides for or restricts the client's options for action.

There is a vast literature on counseling techniques.³ Some years ago, a somewhat paternalistic model was prevalent: the lawyer, because of his knowledge of law and experience, took a dominant role in the relationship. More recently, many lawyers urged and adopted a more client-centered mode of counseling in which the lawyer acts as a friend would, by listening to the client and leaving the major decisions to the

* Robert S. Stevens Professor of Law Emeritus, Cornell Law School. This paper was prepared for the Hofstra Law School 2005 Legal Ethics Conference, October 30-November 1, 2005.

1. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2004).

2. *Id.* at R. 2.1.

3. For a short summary of “the law and ethics of negotiation,” with references to the literature, see GEOFFREY C. HAZARD, JR., SUSAN P. KONIAK, ROGER C. CRAMTON, & GEORGE M. COHEN, *THE LAW AND ETHICS OF LAWYERING* 737-53 (4th ed. 2005).

client.⁴ The actual practice of counseling, of course, is enormously influenced by the nature of the client, the type of legal problem, and whether the representation is an initial consultation or part of a continuing lawyer-client relationship.

I will discuss a much narrower topic, but one which has been the center of much professional discussion and controversy over the last half-century: the duty of a lawyer for a business client to channel the client's conduct along a path that is "within the bounds of the law."⁵ This gives rise, of course, to the related question as to whether the lawyer, who learns that the client is using or has used his services to violate the law, may or must disclose client confidences to prevent or rectify the harm to third persons flowing from the client's wrongful act.

II. THE LAWYER'S ROLE IN PREVENTING CORPORATE FRAUD

Consider the following simple fact situation: Lawyer L has represented C Corp. for several years as its general outside counsel. C Corp. is a closely-held corporation in which most of the stock is held by C, the principal shareholder and CEO. The board of directors is composed largely of C's family and friends, but a portion of the stock is publicly traded. The relationship has produced substantial fees for L's firm, but L has found C to be a difficult and demanding CEO. L discovers in the course of representation that the company has altered consumer transaction documents originally drafted by L in a way that defrauds consumers by a small amount in numerous repetitious transactions. Total fraudulent gains amount to millions of dollars.

L prepares a lengthy legal opinion supporting his belief that the change involved is fraudulent and exposes the company to regulatory penalties, shareholder and consumer actions to recover damages, and adverse publicity. When L meets with the CEO, he argues that the practice should be stopped and rebates offered on future purchases. The CEO rejects this advice and suggests that if L cannot live with the problem, he should resign. What may or must L do?

4. See, e.g., Robert F. Cochran, Jr., *Crime, Confession, and the Counselor-at-Law: Confessions from Dostoyevsky*, 35 HOUS. L. REV. 327 (1998); Robert D. Dinerstein, *Client-Centered Counseling: Reappraisal and Refinement*, 32 ARIZ. L. REV. 501 (1990).

5. A more extensive discussion of this topic is contained in Roger C. Cramton, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 809 (2004) [hereinafter Cramton, *Sarbanes-Oxley*], and Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW 143 (2002) [hereinafter Cramton, *Enron and the Corporate Lawyer*].

The situation should be considered in four stages. First, who is the client? Second, must the lawyer climb the corporate ladder to ascertain the views of the client? Third, if the highest authority of the organization refuses to stop or rectify the criminal fraud, may or must the lawyer blow the whistle? Fourth and finally, may or must the lawyer withdraw?

Only the first question has an easy answer. The lawyer's client is the organization and not the CEO or principal shareholder. Although the CEO retained L, directs his work and can fire him, L's client is the corporate entity, C Corp. And the position of C Corp. on the matter at issue has not been determined.

Must the lawyer climb the corporate ladder to ascertain the views of the client? From 1983 until the amendments to Model Rule 1.13 in August 2003, the ABA's position on this issue was muddled; it combined an apparent requirement that the lawyer act in the best interest of the entity with language that suggested caution, emphasized the importance of confidentiality, and listed three measures, "among others," that the lawyer might take: asking for reconsideration, advising that a separate legal opinion be sought, and taking the matter to a higher authority in the corporation.⁶ Some lawyers read the concern about revealing confidential information outside the organization and the non-exclusive list of options as allowing the lawyer to do nothing. I believe that response was wrong and my view is supported by a few judicial decisions holding lawyers civilly liable for assisting a corporate fraud when they failed to take the matter to higher authority on the ground that it would have been futile to do so.⁷ But it is fair to say that Model Rule 1.13 was something of a mess until 2003.

The 2003 amendment to Model Rule 1.13(b) emphasized the lawyer's duty to act in the best interests of the organization, rather than the interests of its constituents.⁸ The amendment eliminated the

6. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

7. See, *FDIC v. O'Melvey & Myers*, 969 F.2d 744 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *reaff'd on remand*, 61 F.3d 17 (9th Cir. 1995) (a complaint alleging that a law firm acted unlawfully in assisting a bank to defraud third persons stated a claim for relief when the firm knew that the bank's auditor and lawyer had recently resigned and the bank failed to make further inquiry; under these circumstances, a "reasonable, independent investigation" of the client's financial status was required before giving legal opinions and assisting the bank in soliciting investors); *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) (a bank's outside counsel was subject to liability when the lawyers received plausible allegations that the bank's president had defrauded the bank and, relying solely on the president's claim of innocence, failed to inquire further or inform the board of directors of the allegations).

8. For discussion of the 2003 amendments, see Lawrence A. Hamermesh, *The ABA Task Force on Corporate Responsibility and the 2003 Changes to the Model Rules of Professional Conduct*, 17 GEO. J. LEGAL ETHICS 35 (2003).

discussion of relevant factors and the listing of three actions that “may” be taken. More importantly, the text made it clear that referring the matter to a higher authority was required unless the lawyer “reasonably believes that it is not necessary in the best interest of the organization to do so”⁹ Despite the double negative, this is a requirement that the lawyer must proceed up the ladder if that is in the best interest of the organization.

The ABA was not acting on its own in stiffening the up-the-ladder reporting of prospective or ongoing law violations.¹⁰ Shortly before the ABA acted, the Sarbanes-Oxley Act of 2002 required the SEC to promulgate rules of professional conduct to govern lawyers who appear and practice before the Commission on behalf of issuers.¹¹ As a lawyer for a public company issuing securities, L would be subject to the SEC’s up-the-ladder reporting requirement.¹² The SEC rule requires L to report the legal violation to the chief legal officer or CEO of C Corp. and, if an appropriate response is not made in a reasonable period of time, to report the violation to the board of directors or an appropriate committee of the board.

In effect, both Model Rule 1.13(b) and the SEC rule require the lawyer to take steps that will determine the action the corporate entity really wants to take. The organization has internal remedies; it can take steps to countermand the officer whose conduct threatens or entails harm to the corporation. If those steps remedy the problem, the lawyer need not take any further action. Confidentiality is preserved and the company, especially in a prospective action situation, suffers no ill consequences.

Reporting up the corporate ladder to the highest authority almost invariably should lead to the termination of a material violation of law. The fundamental obligation of officers and board members is to act in the best interest of the corporate entity.¹³ If the corporation has a serious

9. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2004).

10. See Cramton, *Sarbanes-Oxley*, *supra* note 5, at 737-40.

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 306, 116 Stat. 745 (2002). For useful discussions of the background circumstances, see John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004), and Susan P. Koniak, *When the Hurlyburly’s Done: The Bar’s Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1239-43 (2003).

12. See Standards of Professional Conduct for Attorneys Rule, 17 C.F.R. pt. 205 (2006) [hereinafter SEC Final Rule] (providing disclosure and withdrawal standards for securities lawyers practicing before the SEC).

13. This established principle of corporate law is restated in the text of Model Rule 1.13(a): “A lawyer employed or retained by an organization represents the organization acting through its

legal problem, and the officer in charge refuses to act or is implicated in the potential or actual illegality, the lawyer must act to protect the entity. That can only be done by going up the corporate ladder to the ultimate authority.

The merit of this approach flows from its effectiveness in curing the problem without harming the corporation by harmful external publicity. The action is effective because, if a clear illegality is involved, board members have no option other than to restrain the officer whose conduct is threatening harm. Under what circumstances would board members so directly flaunt the law? They would be subject to personal liability if they failed to take prudent steps to prevent or rectify the law violation.¹⁴ And the result is achieved by internal action without harmful outside publicity. Thus a stiff reporting-up requirement is the step likely to have the largest effect on the reduction of corporate fraud and illegality. That is why the SEC has made it the cornerstone of its corporate governance steps relating to lawyers.

But suppose a rare case: The board, C Corp.'s highest authority, flaunts the law and refuses to take appropriate remedial action. May or must the lawyer disclose the confidential information to prevent harm to the corporation and third persons? The SEC rule requires lawyers who appear and practice before the SEC in the representation of issuers to report evidence of a material violation of law or breach of fiduciary duty by the issuer or its agent to its chief legal counsel or CEO.¹⁵ If the chief legal officer or CEO fails to provide "an appropriate response" to the evidence, the lawyer must report the evidence to an appropriate committee of the board or to the full board.¹⁶

The 2003 ABA amendment provides for permissive disclosure when the highest authority fails to address a violation of law.¹⁷ Disclosure outside the client organization may be made on two conditions. First, the company's highest authority refuses to address a "clear" violation of law.¹⁸ And second, "the lawyer reasonably believes

duly authorized constituents." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2004); *see also id.* at cmts. 1-3 (describing the principle in more detail).

14. For a discussion of the civil liability of corporate officers for actions harmful to the organization or third persons, see Cramton, *Enron and the Corporate Lawyer*, *supra* note 5, at 145-58, 167-73.

15. SEC Final Rule, *supra* note 12, § 205.3(b).

16. *Id.* § 205.3(b)(3).

17. For a comparison of ABA Model Rule 1.13 prior to August 2003 with the amendment of that date, see THOMAS D. MORGAN & RONALD D. ROTUNDA, 2005 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY 54-60 (2005) (reprinting Rule 1.13 as amended in August 2003 in the text with an accompanying footnote containing the prior version of the rule).

18. MODEL RULES OF PROF'L CONDUCT R. 1.13(a)(1) (2004).

that the violation is reasonably certain to result in substantial injury to the organization.”¹⁹

In the hypothetical posed, these requirements are met. My background assumption is that a state or federal regulatory law clearly prohibits the billing practice that the company has included in its consumer sales. The violation of law need not be criminal, although probably the intentional inclusion of illegal charges would constitute criminal as well as civil fraud. The second requirement is also met because the billing practice results in a large total loss by consumers and threatens the company with even greater harm if the public learns of its criminal or fraudulent conduct. The permissible disclosure under Model Rule 1.13(c) can be made “whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.”²⁰ And disclosure is the only way to prevent the injury.

The fourth and final issue, unlike the changing and divided views on outside disclosure of confidential information, has never changed over the years. A lawyer is required to “withdraw from the representation of a client if . . . [continued] representation will result in violation of the rules of professional conduct or other law.”²¹ If the client is engaged in a criminal or fraudulent course of conduct, continued representation is likely to further or assist the client in perpetrating the fraud. This violates Model Rule 1.2(d), which prohibits a lawyer from counseling or assisting a client in conduct that the lawyer knows is criminal or fraudulent.²² Thus, withdrawal is required in the hypothetical I have been discussing once the client persists in the illegal practice after the highest authority of the client fails to stop or remedy the illegal conduct.

Monroe Freedman, one of the leading figures in the field of American legal ethics, states very different views in his treatise and in a recent article entitled, “The ‘Corporate Watch Dogs’ That Can’t Bark: How the New ABA Ethical Rules Protect Corporate Fraud.”²³ He describes the 2003 amendment as “a drafting and public-relations scam that has persuaded the public and commentators that corporate lawyers

19. *Id.* at R. 1.13(c)(2).

20. *Id.* at R. 1.13(c).

21. *Id.* at R. 1.16(a)-(a)(1).

22. *Id.* at R. 1.2(d).

23. Monroe H. Freedman, *The “Corporate Watch Dogs” That Can’t Bark: How the New ABA Ethical Rules Protect Corporate Fraud*, 8 UDC/DCSL L. REV. 225 (2004).

are now permitted to report their clients' frauds."²⁴ But, he argues, the new rule does not make them "corporate watchdogs" because they "are forbidden to bark."²⁵

Freedman, discussing a situation very much like my hypothetical, states that the lawyer for C Corp. cannot seek to rectify or mitigate the fraud by means of a disclosure under Model Rule 1.13(c) for three reasons. First, the board's failure to take remedial action is not "clearly" criminal. Second, the board's failure to act is not "certain" to cause "substantial injury to the organization" because it is unlikely that the fraud will ever be discovered by anyone. And, third, for the same reason, reporting out is not "necessary" to prevent "substantial injury to the organization."²⁶

The first argument, that "the board's failure to [take appropriate remedial action] is not clearly criminal,"²⁷ contains two errors. One is that the conduct in question need not be a crime. Model Rule 1.13 applies to any action, or refusal to act, by a corporate officer or employee that breaches a fiduciary duty the person owes to the corporation or that "reasonably might be imputed to the organization."²⁸ Many, perhaps most, of those "violations of law" will be civil rather than criminal in character, such as breaches of tort or regulatory law that carry civil penalties. Freedman also errs in stating that the rule turns on whether or not the board's failure to take action is or is not a violation of law. The decisive consideration is the board's failure to take action to prevent or remedy the original violation of law.

Freedman's second argument, that "the board's failure to take remedial action is not 'reasonably *certain*' to injure the company substantially"²⁹ because, he states, "the fraud is not likely to be detected, so there is not likely to be substantial injury to the corporation if the lawyer remains silent. Accordingly, [Freedman concludes] the lawyer is *forbidden* to go up the ladder."³⁰ In the language of the rule, the question is whether, in the hypothetical posed, "the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization."³¹ The objection that no injury has occurred until the victims or the world know about it clearly has no application to an

24. *Id.* at 225.

25. *Id.*

26. *Id.* at 227-28 (emphasis omitted).

27. *Id.* at 231.

28. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

29. Freedman, *supra* note 23, at 230 (emphasis added).

30. *Id.* at 229.

31. MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(2) (2004).

officer's breach of a fiduciary duty to the corporation. When an officer is filling his own pockets at the expense of the company, the corporation suffers an immediate harm. With respect to imputed violations of law, in which the corporation or third persons are harmed, Freedman argues that a lawyer may or must conclude that there is no "substantial injury to the organization" unless the constituent's crime, fraud or other violation is likely to become generally known.³²

I tested Freedman's argument, which is an extreme version of legal realism, by posing his hypothetical to three individuals who were major participants in the drafting and adoption of the 2003 version of Model Rule 1.13. They each agreed that a lawyer may reasonably believe that a "substantial injury" is "reasonably certain" when a company has embarked on a course of conduct that involves stealing large amounts of money from its customers. The conduct is clearly a violation of law, it is substantial in character and one cannot blithely assume that the harm to the organization will never materialize because the fraud will not be discovered.

Truth and morality are important parts of our law and play large roles in its interpretation; they are not values that should be assumed not to exist in interpreting law. And, if that is not enough to determine the meaning of "reasonably certain" and "substantial injury," it can be argued that the likelihood of exposure meets both requirements. Auditors may uncover the fraud at any time and they have a legal duty to report legal violations publicly. Regulators may respond to consumer complaints. Or a stubborn customer may stumble on the charge and pursue it even though the amount is small. It should not be assumed in our open society that chicanery can be concealed forever. And it certainly should not be assumed that lawyers will participate in the coverup. Freedman's argument, in essence, rests on an assumption that business corporations will defraud, corporate lawyers will assist them in doing so, and regulators, consumers and the public will pay no attention.

Freedman's third and final argument is a repetition of the second one, already considered. The last clause of Model Rule 1.13(c) permits disclosure, "but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."³³ Here the emphasis is on whether the disclosure is "necessary" to prevent the "substantial injury." My argument in response would repeat much of what I have already said.

32. See Freedman, *supra* note 23, at 232.

33. MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2004).

I agree with Freedman's criticism in one respect. The language used in the revision of Model Rule 1.13 creates unnecessary interpretive problems and, as Freedman states, never mentions the public interest in protecting investors and other third persons from injury. The language of the SEC rule permitting disclosure after the reporting-up requirements have proved unsuccessful is much simpler, clearer and better: it speaks of a lawyer revealing information to prevent or rectify "the [organization] from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors."³⁴ Model Rule 1.13 would be improved by eliminating the ambiguities of "clearly," "certain" and "necessary"—restrictive terms that create unnecessary interpretive problems.

One other aspect of Freedman's interpretation of Model Rule 1.13 is worth mention. In addition to misreading the text of the rule, he totally ignores the official comments to the rule, which directly contradict his assertions and conclusions, and almost totally ignores the context that gave rise to the rule, the explanations of it provided by the ABA, and the interpretive comments of others concerning it.³⁵ His apparent background view that businesses will defraud, the lawyers who represent them will assist in the fraud, and everyone else will pay no attention leads him to read the rule's language so that it fits his preconceptions.

The relationship between Model Rule 1.13 and other rules is not mentioned by Freedman but is an important and neglected issue. The addition of permissive disclosure under the rule, often referred to as "reporting out," is not the only provision of state ethics rules that permit or require disclosure. Those provisions supplement Model Rule 1.13 and are not replaced by it. This is made clear by the history and language of the two rules. For example, Rule 1.13(c) states explicitly that it applies "whether or not Rule 1.6 permits such disclosure."³⁶

Thus, the rule generally governing exceptions to confidentiality is an alternative source of law permitting or requiring a lawyer to disclose confidential information to prevent, mitigate or rectify a prospective or ongoing client crime or fraud. And state ethics rules, today and formerly, have more and broader exceptions to confidentiality than are found in the Model Rules. For example, even in its broadened 2003 form, Model

34. SEC Final Rule, *supra* note 12, § 205.3(d)(2)(i).

35. The societal concern in the years following the Enron collapse that accountants and lawyers were assisting company officials by conduct prejudicial to the interests of the corporate entity is discussed in the Coffee article, *supra* note 11. The bar's reaction to that concern is discussed in the Hamermesh article, *supra* note 8.

36. MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2004).

Rule 1.6 does not permit disclosure of a client's intention to commit a crime.³⁷ Thirty of the fifty-one United States jurisdictions either permit or require such disclosure.³⁸ And forty-four states require, and three more permit, disclosure of a client's ongoing crime or fraud, which was allowed under the Model Rules prior to 2003 only pursuant to a comment providing for "noisy withdrawal."³⁹

But there is more. A third and much neglected rule, Model Rule 4.1(b), *requires* a lawyer "to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6."⁴⁰ Assume that L has gone up the corporate ladder and the client, C Corp., intends to defraud new customers by imposing a criminal or fraudulent charge. Also assume that some of the documents employed in these continuing transactions were prepared by lawyer L. Any continued representation by L will assist the client's wrongdoing. Once L learns of the ongoing fraud, L must take further steps to avoid assisting a client in conduct that the lawyer knows is criminal or fraudulent, which is a violation of Model Rule 1.2(d). And that same knowledge triggers the obligation to disclose material facts "unless disclosure is prohibited by Rule 1.6."⁴¹

Comment 3 to Model Rule 4.1(b) addresses the situation when a client's crime or fraud takes the form of a lie or misrepresentation:

Ordinarily, a lawyer can avoid assisting a client's crime or fraud by withdrawing from the representation. Sometimes it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm an opinion, document, affirmation or the like. In extreme cases, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client's crime or fraud. If the lawyer can avoid assisting a client's crime or fraud only by disclosing this information, then under [Model Rule 4.1(b)] the lawyer is required to do so, unless the disclosure is prohibited by Rule 1.6.⁴²

As we have seen, the current Model Rule 1.6(b)(2)-(3) permits disclosure to prevent or rectify a crime or fraud in which the lawyer's

37. *Id.* at R. 1.6.

38. See ATT'YS' LIAB. ASSURANCE SOC'Y, INC., *Ethics Rules on Client Confidences*, in MORGAN & ROTUNDA, *supra* note 17, at 144, 146-49 col. A (tabulating the current law of all U.S. jurisdictions on disclosure of confidential information to prevent harm to third persons).

39. *Id.* at 146-49 col. G.

40. MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (2004).

41. *Id.*

42. *Id.* at cmt. 3.

services have been used.⁴³ Model Rule 4.1(b) turns that permission into a requirement when the lawyer's work is involved in a client's prospective or ongoing fraud. Thus, an analysis by the Attorneys' Liability Assurance Society—the malpractice insurer of many large U.S. law firms—concludes that forty-four state jurisdictions require disclosure in this situation, two others permit it, and the remaining states require the lawyer to resign, which L must do anyway after all internal remedies have been exhausted and the lawyer's remonstrations have failed.⁴⁴

Model Rule 4.1(b) has the important effect of making it clear that silent withdrawal in some situations will not suffice. The client plans to continue to use the lawyer's work to defraud others. When the misconduct becomes known, as it probably will, the lawyer's failure to act after acquiring full knowledge of the client's ongoing criminal conduct gives rise to a civil liability suit against L. The suit is likely to damage L's reputation and expose him and his firm to great expense.

Have the three rules I have discussed, Model Rules 1.13, 1.6 and 4.1, actually had the effect of shaping lawyer behavior? I think the SEC gave a strong boost to the absolutely essential requirement that the lawyer go up the corporate ladder. At least with publicly traded companies, a lawyer can no longer treat the principal manager as the client and ignore the interests of the entity and its shareholders. And the rules surely trigger a lot of silent withdrawal. But lawyer participation in hundreds if not thousands of major corporate frauds over the years gives rise to some justifiable skepticism about whether these rules actually control the behavior of business lawyers.

We do know several things. Except for the most egregious instances of knowingly assisting a client's criminal or fraudulent conduct, lawyers are never disciplined for failing to go up the ladder, for not withdrawing when they should, or for not disclosing a prospective or ongoing fraud even when the failure to do so assisted the client's wrongdoing. The only remedies come in the form of civil liability suits by those harmed or a very occasional criminal prosecution in an egregious case. But those remedies have considerable bite. Typical malpractice arrangements provide for a large deductible (perhaps \$1 million in the case of a large law firm) and require the firm to bear the expense of the litigation. So potential losses are large and worrisome,

43. *Id.* at R. 1.6(b)(2)-(3).

44. See ATT'YS' LIAB. ASSURANCE SOC'Y, INC., *Ethics Rules on Client Confidences*, in MORGAN & ROTUNDA, *supra* note 17, at 144, 146-49 (2004).

and loss prevention activity on the part of law firms tries to prevent such claims from arising.⁴⁵

But the decentralized structure of many firms today, and compensation policies that make partner earnings dependent on fees earned, work in the other direction. The firm wants to prevent C Corp. from exposing it to a major damage claim; but C Corp.'s fees may be a large portion of lawyer L's earnings for the firm. In short, law firms encounter an agency problem that is difficult to deal with and often limits the action taken to a silent withdrawal at a very late stage.

III. SOME UNSOLICITED ADVICE

I conclude with some unsolicited words of advice culled from my study of corporate fraud situations over the years:

First, make sure that the board of directors, or an appropriate committee of the board containing independent directors, signs off on major matters that involve substantial legal risk after being fully informed of those risks. Always bear in mind that your client is the corporate entity and not the managers who provide direction on a day-by-day basis. All corporate frauds start with lawyers treating senior management as the client and failing to communicate with higher authority within management, or if management is the problem, to the board of directors, who are the ultimate authority on all matters except those on which shareholders must act. It is natural for you to defer to the interests and desires of the managers who hired you, direct your work and can fire you. But when facts arise that suggest a substantial legal problem, such as a material violation of law by a division manager or a self-dealing arrangement proposed by a dominant manager, you must be sure that higher authority within the corporation is informed of the situation, has taken appropriate steps to evaluate it and, if necessary, acts to prevent or rectify any wrongdoing.

Second, in shaping future business transactions for a corporate client, try to work only for clients who want a legal advisor who will chart a prudent course through the shoals of the law. Beware of corporate managers who push you to be "creative and aggressive" in exploring the limits of the law. The business lawyer is a counselor and advisor, not a litigator, and the goal is a sound result that will advance the interests of the client "within the bounds of the law." Wise counseling involves a prudent awareness of the existence of legal risk

45. See generally Geoffrey C. Hazard, Jr., *How to Cut the Cost of Malpractice*, NAT'L L.J., Dec. 17, 1990, at 15-16.

and not an effort in every situation to test how far the envelope of the law may be pushed. Lawyers who take the latter approach run a grave risk of assisting illegal conduct. If you cast prudence aside and take large legal risks, your work may become the subject of public litigation under very adverse conditions: Jurors don't like lawyers or corporate managers and the "hindsight bias" will operate against you. If the transaction has harmed third parties and appears to be fraudulent or illegal, your claim that you did not "know" what the managers were really doing will fall on deaf ears.

Third, do not assume the attorney-client or work-product immunity privileges will protect legal files or lawyer-client communications. Any transaction can go sour and, if it does, it is likely to be subject to after-the-fact scrutiny. If the SEC or a state or federal prosecutor begins an inquiry, the corporation is likely to "cooperate" with the inquiry. Large corporate frauds almost invariably result in change of control and often in bankruptcy; successors in interest will waive the confidentiality in an effort to recover assets from the managers who looted the enterprise and the lawyers and accountants who assisted them. Even in the cases when waiver does not occur, the fraud victims probably will be successful in using the crime-fraud exception to penetrate the privilege.

Fourth, you will not avoid civil liability by portraying your job as a lawyer narrowly and attempting to place the blame on others. Lawyers involved in client fraud situations almost invariably assert that agents of the client lied to them, they did not know of facts indicating fraud, and they reasonably relied on the decisions of officers and directors of the company on business decisions and on the judgments of eminent accountants on all accounting-related matters. They were legal technicians—scriveners—not professionals with a broad responsibility. They claim, therefore, that the legal advice they gave was proper under the circumstances and that all the wrongdoing is attributable to other actors. At the same time, those other actors—the company's officers and directors and the outside accountants—are claiming that they also had limited knowledge and relied on the legal advice of the lawyers. The "circle of blame" that results is a classic (and generally unsuccessful) attempt at avoidance of responsibility, since each provides evidence against the others. More broadly, lawyers cannot absolve themselves from legal responsibility by pretending that only business or accounting decisions are involved, just as managers and accountants cannot avoid responsibility by claiming that they relied on lawyers. If a series of transactions has no substantial business purpose (i.e., no property or risk is transferred to a third party) and the facts and circumstances suggest

that their sole function is to give the company's balance sheet a false boost, legal questions are raised that are not resolved by an accountant's approval.

Some years ago, Louis Brandeis was being questioned by a Senate committee about the generality and vagueness of the Sherman Act. Businessmen argued that the law was unfair because its boundaries were not clear. Brandeis replied to them as follows:

[Y]our lawyers . . . can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go . . . because you may stumble on a loose stone, . . . slip and go over; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice. The difficulty which men have felt . . . has been rather that they have wanted to go the limit rather than that they have wanted to go safely.⁴⁶

That is great advice from a great man!

QUESTION AND ANSWER

PROFESSOR FREEDMAN: My first observation is that having heard Roger's rebuttal, which I do appreciate, Roger who has been paying attention anyway up to a point. I hope having heard the rebuttal, you will read the argument. One place it appears is in *Understanding Lawyers' Ethics* at 147 to 151,⁴⁷ but I happen to have by chance in my office some reprints, and I'll leave a stack out, and you can pick them up. In some respect, Roger's defense of Rule 1.13 is a rather strange, and I think self-defeating one. First, he says that it is ambiguous. It is subject to the kind of reading that I give it or at least to a reading different from his own. He acknowledges that it makes repeated references to the lawyer restricting her conduct to the best interest of the corporation. He acknowledges that no place in 1.13 does it ever mention concern for the interest of third parties, which is what the fraud provisions in 1.6 are all about. And then he says, in effect, if I understand him, that it's superfluous anyway, because you got 1.6, you got 4.1, you got 4.4, you got the lawyer's obligation to her client, which is the entity. So the lawyer doesn't need the instructions from 1.13 to go up the ladder to the board of directors, which is ordinarily understood to be the embodiment of the entity. If we don't need it, if it's ambiguous, and if it can be read

46. HARRY FIRST, *BUSINESS CRIME: CASES AND MATERIALS* 27 (1990) (quoting Louis D. Brandeis, *Hearings before the S. Comm on Interstate Commerce on S. 98*, 62nd Cong. 1161 (1911)).

47. MONROE H. FREEDMAN & ABBE SMITH, *UNDERSTANDING LAWYERS' ETHICS* 147-51 (3d ed. 2004).

as contradicting all of these other rules in the corporate context, let's just get rid of it.

I remember my first objection back in 1983 to the earlier version of 1.13, which did the same thing virtually. They've only typed it up and made it more favorable to the corporation in this fraud on the public in making them think that we have a real reporting up and reporting out provision. I was debating with Geoff Hazard, and Geoff said, "Monroe, all of this is irrelevant, all 1.13 does is to establish that the corporate client is the entity, the corporation is the client of the lawyer of the corporation." I said, "Geoff, we can rewrite that about that law. We don't need this whole provision with all of this language about making sure you do nothing that's inconsistent with the best interest of the corporation." And Roger has changed the hypothetical that I gave. He left totally ambiguous the key element in my hypothetical, and he presented it to people who drafted it. I'd be interested to know on the hypothetical that I give what the result is.

My view of 1.13 is that it does require the lawyer to go up, it does require the lawyer to report out in one circumstance only, and that is when the information is going to get out anyway. If it's likely to get out anyway then the lawyer can go up and can go out, but if the lawyer makes the judgment that it is not likely to get out, there's a good chance these people are going to get away with this forever, then the lawyer is absolutely forbidden by 1.13, no ambiguity. The express language, the lawyer is forbidden to report out and to report up. Give that hypothetical, which is my very simple hypothetical to the people who drafted a situation where the lawyer makes the judgment, it is not likely that the corporation is going to get caught in its overseas bribery or its small frauds on a lot of people that amount to a lot, and ask them what the result is then, and make sure that they reread what they drafted.

Now, Roger, first of all, my recommendation to the New York people is that they just leave out 1.13. It contributes nothing to 1.6, 4.1 and other provisions. My recommendation is leave it out, but, Roger, if you want to sit down with me, we'll redraft this, take out the ambiguity, put in the interest of third parties, take out the overriding concern for the welfare of the corporation as the exclusive concern of 1.13. I'll join with you in doing it.

PROFESSOR CRAMTON: A brief response, then I'll get more questions and comments from the floor. In agreeing with you on some problems of the existing drafting, I was concentrating on just making every word clear and certainly necessary. I think the rule would have been better if other words were used than those in the rule. I think the

view is that 1.13 is superfluous and does nothing—I'm astonished that Geoff Hazard should acknowledge it as an established entity rule. There's no point in having it. That's part of the regular law anyway, but why don't you put that in the textbook? Corporate law makes that point. But you agree with me I guess that in some situations it does require up the ladder, and in some situations it does require disclosure outside. What you do is rebuild the concept of substantial injury, from the point of view that there's some possibility that the frauds on a very large scale won't be discovered.

Well, a lawyer that makes that judgment in a case in which you can have whistle blowers, in a case in which there is a lot of information sources, and people follow the listed public company closely, and the shareholders do, the information has a way of getting out. It's hard to cover up chicanery over a long, long period. So lawyers ought to assume their clients, their corporations want to stay within the bounds of law, whereas you just assume that they want to violate the law, and because they can make more money by violating the law, lawyers kind of unknowingly or even willingly assist them in doing that, and I just resist that notion. I think corporations want to comply with the law, and their counsel staff inside and outside try to assist them to that end. When they take that advice to the board about what is lawful and what is unlawful and so on, even in an ambiguous situation, where they get the advice, but the lawyer said: "Well, it's maybe okay but there are serious legal problems, there will probably be litigation and so on," many businessmen are very reluctant to go ahead. So I just think that your world is too much influenced by preconceptions that corporations want to violate the law, the lawyers they hire don't care if they do, and kind of assist them in doing that, and that the law and legal system regulators do nothing about it, and are totally uninterested in the problem.

PROFESSOR NEEDHAM: Hi. I'm Carol Needham, St. Louis University. I have to respectfully weigh in that I disagree with Monroe. I agree with Roger on this point, that it cannot turn on the likelihood of discovery. The likelihood of discovery absolutely cannot be the linchpin, but I have to disagree with Roger—I'm really setting myself up for attack here taking on both—that you have to think about the background against which you're asking lawyers to act, and when you were talking about there being no discipline against lawyers that go up the ladder, I agree. There really is no record of such, but think about the position of in-house counsel. In many jurisdictions there is no cause of action for retaliatory discharge. There is no protection under whistle blowers statutes. Even statutes that on their face are written explicitly to protect a

person who discovers various kinds of harm, which is precisely the harm discovered by this particular in-house counsel. That counsel is not protected, because they have to keep the confidentiality as the attorney. Essentially, I think the key is the language in Rule 1.6, to the extent that that determines the extent of the protection under the duty of confidentiality of the information of the client, when you take out even the generally known phrase in the current language of the model rules, and you take out the other law. I mean that doesn't vitiate it, but even as it stands, even if you plug it back in generally known, and some states have taken out other law and plugged that back in, you still don't have an adequate opening exception to the rule of confidentiality for in-house counsel to allow them to make the revelation that you would like to see made. So my question to you is, what language would you like to see in Rule 1.6 that would permit disclosure in the circumstances?

PROFESSOR CRAMTON: Well, first, what the SEC includes in its rules is protection against retaliation against whistle blowers, and some states have whistle blowers statutes that do the same thing, and some of them have been interpreted as applying to lawyers, and that can be expanded. More states can provide for remedies for in-house counsel and in some situations for outside counsel, well, that's a very different problem. They don't have the vulnerability and they can withdraw, but you're right, inside counsel cannot withdraw without resigning their lawyer and looking for another job, but you made very good comments, and law reform efforts in this area are needed, and I'm delighted to collaborate with more people who want to make useful improvements in the law.

MR. SHIRLEY: Evan Shirley from Honolulu, Hawaii. This is more in the nature of a comment than a question. The language that Rule 1.13 turns on that we're all discussing is there's likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. It's important I think in fraud cases to point out there is no statute of limitations for fraud. That many jurisdictions look at it as the longest period of statute of limitations from the time of discovery of the fraud, so that a lawyer may look at the situation that is occurring now in 2005, and it may not be discovered for four or five years from now. Yet the corporation, the interests of the organization will be substantially harmed four or five years from now with no statute of limitations, another six year statute, or five year statute. And I think Monroe acknowledges that when he said it's likely to get away with it forever, and I think there's an interesting

case, it's *Yellow Cab Co.*⁴⁸ It comes from the California Supreme Court. What *Yellow Cab* did was systematically set their meters ahead by about one-half of one percent, and it took a map maker to the airport from downtown Los Angeles to LA International. And he kept going to the airport on a number of occasions, and he would ask the cab driver to follow a precise route, and he'd go back and he calculated it again, and he realized that each time he was being charged .005 more than what the fare should be, which resulted in a rather substantial, I think it was like an \$11 million judgment against the Yellow Cab Company. That had to be paid out of corporate profits, not as an expense. It was specifically ordered that way. They couldn't deduct the fraud, so you never really know what circumstances are going to occur. I'm sure that Yellow Cab Company never anticipated having a map maker discover such a fraud. But my point mainly was that statute of limitations point that it just continues, and the person who's committing the fraud can't say: "You should have filed the action earlier, because we covered it up substantially." That's all.

PROFESSOR SIMON: Just a quick comment to bring that closer to home. Many people have been reading about the theft of \$11.4 million from the Roslyn School District. How was this discovered? Was it discovered through the independent auditors who vigilantly checked or were supposed to check everything? No, it was discovered when a Home Depot clerk called the school district and said: "You know, are people allowed to buy stuff for themselves and their personal home improvements on a school credit card?"

MS. STRETCH: Becky Stretch from the ABA. I think Monroe is totally correct about this and I really wish they had written it differently, but I still believe that Monroe's paper doesn't acknowledge that 1.13(c) is in addition to 1.6(b), and Monroe is correct that it could be a whole lot clearer than that is the case—but comment six to Rule 1.13 is about relations to other rules, and it does say that paragraph (c) of this rule supplements Rule 1.6(b) by providing an additional basis upon which the lawyer may reveal information. So I think the significant thing about 1.13, even though it could have been written a whole lot better and it's probably too protective in that sense, is an additional disclosure option for the lawyer of a corporation even though his services were not used. Under 1.6, the disclosure is only if the lawyer services were used, so under 1.13, the lawyer may disclose even though his services were not used, under the limited circumstances described in 1.13. And, yes, it's

48. *Daar v. Yellow Cab Co.*, 433 P.2d 732, 736-37 (Cal. 1967).

probably not written beautifully, and we could certainly do a better job and some people did suggest better language, but we also move differently in different places, but I know we probably have to move on—I hope I’ve explained that.

PROFESSOR CRAMTON: It’s very helpful.

PROFESSOR FREEDMAN: That’s also answered in my article. I won’t go into how.

PROFESSOR SIMON: We have to move on to the next speaker, but I’m glad that this has generated such a lively discussion. I thank Roger Cramton very much for a provocative and interesting address. [Applause]